



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

August 20, 2002

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, DC 20515-6115

Dear Congressman Dingell:

In your letter dated May 15, 2001, you asked for a follow-up report on the progress of the National Association of Securities Dealers, Inc. in implementing certain undertakings the Commission had ordered as part of its settlement of an enforcement action against the NASD for failure to enforce adequately its own rules. Your letter identified three items in our May 2001 report as outstanding matters or continuing deficiencies. The attached memorandum, prepared by my staff, provides an update regarding each of these items.

Overall, I believe the remedial actions undertaken by the NASD have significantly enhanced the Nasdaq Stock Market to the benefit of investors. The NASD has continued to commit substantial resources to fulfill the fourteen undertakings required by the Commission in its 1996 enforcement action. As more fully described in the staff memorandum, substantial progress has been made in each of the three areas identified in your letter. We are continuing to monitor these efforts.

Thank you for your interest in the NASD's efforts. If you have questions or comments, please do not hesitate to contact me or Annette L. Nazareth, Director of the SEC's Division of Market Regulation, at (202) 942-0090.

Yours truly,

A handwritten signature in black ink, appearing to read "Harvey L. Pitt".

Harvey L. Pitt

Enclosure

The Honorable John D. Dingell
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cc: The Honorable W.J. "Billy" Tauzin, Chairman
Committee on Energy and Commerce

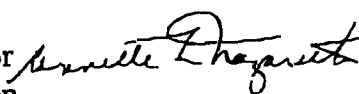
The Honorable Michael G. Oxley, Chairman
Committee on Financial Services

The Honorable John J. LaFalce, Ranking Member
Committee on Financial Services

MEMORANDUM

TO: Harvey L. Pitt, Chairman

FROM: Annette L. Nazareth, Director
Division of Market Regulation



DATE: August 8, 2002

SUBJECT: Update: Status and Effectiveness of NASD Actions Since the 21(a) Report

This memorandum responds to Congressman Dingell's letter dated May 15, 2001, requesting an update of the Commission's comprehensive report, dated May 8, 2001 ("2001 Report"), on the progress of the National Association of Securities Dealers, Inc. ("NASD") in fulfilling the fourteen undertakings required by the Commission in its 1996 order ("SEC Order"). Congressman Dingell enumerates three items identified in our 2001 Report as outstanding matters or continuing deficiencies.¹

1. Status of a restricted list and systems changes for monitoring applicable short sale and holding-period restrictions.

Update. As previously reported in the 2001 Report, system enhancements for monitoring compliance with the 90-day holding period and net short prohibitions became operational during the first quarter of 2001. The first exception reports were generated to include the entire 2000 calendar year and were distributed to management on April 12, 2001. Since that initial set of reports was distributed, the NASD Office of General Counsel ("OGC") advises us that it has generated and distributed exception reports on a quarterly basis. Exception reports are generated as soon as data entry for a particular calendar quarter has been completed. NASD management reviews the exception reports, and OGC confirms with management that appropriate action has been taken for violations discovered. The nature of the disciplinary action depends on the seriousness of the violation and can range from a warning to unwinding a violative transaction and disgorging any profits and termination. There have been three violations detected to date. The NASD determined that these violations were inadvertent, and therefore, no formal disciplinary action was taken. The SEC staff is satisfied with NASD's progress in implementing this undertaking and believes the NASD is in compliance with this undertaking.

¹ In responding to Congressman Dingell's inquiry, we have relied, in part, upon the representations of NASD staff.

2. Status of implementation of OATS (NASD's Order Audit Trail System).

Update. Since April 2001, NASD has continued its efforts to ensure that a complete, accurate, and timely audit trail of orders exists so that NASD can adequately surveil activity under its jurisdiction. OGC reports that, at present, the OATS system is efficiently processing an average of 65 million order reports per day, as opposed to 25 million in January 2001 and 3.5 million order reports at the inception of OATS. NASD has six full-time positions that continue to be dedicated to OATS compliance. To address the overall data integrity of OATS, OGC reports that throughout 2001 to the present, NASD staff² initiated regulatory reviews specifically focused on enhancing the quality and timeliness of the OATS data. NASD conducts five separate OATS sweeps each quarter of 10 firms for a total of 200 firms per year. Firms are selected based on concentration of violations. These reviews focus on missing and late data submissions, failure to repair rejected reports, failure to submit required records, the inability to match orders to trades, and failure to report OATS events in a time-sequenced manner.³

One example of the effectiveness of these reviews is the increased percentage of executed orders that now can be matched to the related trade report. In January 2001, OGC reported that the percentage of executed orders that could be matched to the related trade report was approximately 79%. In June 2002, the matching rate had increased to approximately 93%.⁴

In addition, since April 2001, NASD initiated an additional 126 formal or informal disciplinary actions for non-compliance with the OATS rules. The total number of formal or informal disciplinary actions for noncompliance completed or pending since 1999 is 217.

SEC staff is currently preparing to inspect these aspects of NASD's OATS system.

The SEC staff is also currently reviewing an NASD rule proposal related to OATS. The incorporation of manual orders into the OATS data stream has raised significant

² As a result of NASD's corporate restructuring, NASD Regulation, Inc. is now the Market Regulation Department of Regulatory Policy and Oversight of the NASD.

³ OGC had planned to conduct a review to ensure that orders could be linked between members. The need for this review was obviated by the implementation, in early 2002, of a system validation that requires the entry of a routed order number for linking. If a routing report is submitted to OATS without the necessary information to link the record, it will be rejected by the OATS system and the member will be required to add information and resubmit the record. As noted above, if a member's OATS records are rejected by the OATS system, this activity is monitored through one of the OATS compliance reviews.

⁴ This percentage reflects the match rate for trades executed and reported to Nasdaq via ACT by NASD members and therefore, under NASD's regulatory jurisdiction. Trades reported to other SROs and/or national securities exchanges are not included in the matching statistics.

technical issues, and SEC staff is working with the NASD and the securities industry to devise appropriate solutions.

3. NASD surveillance and examination of order handling: status of SEC's Office of Compliance Inspections and Examinations ("OCIE") inspection and NASD's Trading and Market Maker Surveillance ("TMMS") examination unit.

Update. OCIE completed its inspection of NASD's Trading and Market Maker Surveillance examination program and the impact of OATS on NASD's automated surveillance efforts in August 2001. The SEC staff found no significant deficiencies, but recommended that NASD enhance existing procedures and continue its efforts to automate several surveillance programs. NASD agreed to implement the SEC staff's recommendations. OCIE's inspection of NASD's disciplinary program is ongoing and is not complete. The SEC staff has also initiated a follow-up inspection of the NASD to evaluate its regulatory program regarding OATS and the use of OATS data in its surveillance programs. This inspection is also ongoing.

To respond to the underlying question of whether the SEC is satisfied with the NASD's progress in surveilling for trade reporting violations, the SEC staff believes that NASD has substantially fulfilled the undertaking in the 1996 Order.⁵ The undertaking required the NASD to "improve substantially the reliability of trade reporting, through, among other things, enhancement of surveillance, examination, and enforcement."⁶ NASD states that it continues to conduct a number of specific reviews that examine for potential trade reporting violations, including concentrated instances of late trade reporting and the misuse of trade reporting modifiers. NASD conducts six trade-reporting sweeps per year focusing on ACT reporting, riskless principal, order entry, and a global sweep focusing on concentrated trade reporting of different market classes. These sweeps focus on firms that are the furthest outliers in relation to their peer group. As a result of these reviews, the NASD has brought over 124 formal or informal disciplinary actions since April 2001. Moreover, the 1996 Order noted that 4.5% of Nasdaq National Market trades were reported late during the period February through December 1994. NASD states that for the first six months of 2002, the percentage of late trades has decreased to about one-tenth of that figure, namely .47%.⁷

⁵ See Securities Exchange Act Release No. 37538 (August 8, 1996) ("1996 Order").

⁶ See 1996 Order, at 12.

⁷ This statistic is for Nasdaq National Market and SmallCap securities combined. Excluded from this statistic are trades executed through SOES, SuperSOES, and SelectNet, which when included, drops the overall late trade reporting rate for Nasdaq issues to .33%.